VZCZCXRO2548
RR RUEHCHI RUEHDT RUEHHM RUEHNH
DE RUEHKL #1390/01 2080906
ZNR UUUUU ZZH
R 270906Z JUL 06
FM AMEMBASSY KUALA LUMPUR
TO RUEHC/SECSTATE WASHDC 7196
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/USDOC WASHDC
RUEHGV/USMISSION GENEVA 1419
RUCNASE/ASEAN MEMBER COLLECTIVE

UNCLAS SECTION 01 OF 03 KUALA LUMPUR 001390

SIPDIS

STATE PASS USTR - WEISEL AND JENSEN
STATE PASS FEDERAL RESERVE AND EXIMBANK
STATE PASS FEDERAL RESERVE SAN FRANCISCO TCURRAN
USDOC FOR 4430/MAC/EAP/J.BAKER
TREASURY FOR OASIA AND IRS
GENEVA FOR USTR

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN EINV EPET MY
SUBJECT: Dueling Forecasts: Malaysia Economic Update for July 2006

REF: Kuala Lumpur 0797

¶1. (U) Summary: Government officials insist that the economy is on track to meet their target of 6.0% growth in 2006, but Malaysia's most prestigious private forecaster recently downgraded its forecast to 5.2%. Private inflation forecasts are more in line with the Central Bank's projection of 3.5-4.0% for the year, though private analysts expect inflation to be at the top of that range. The government says it is satisfied with the current ringgit exchange rate, but most private analysts believe it remains undervalued a year after its depegging from the dollar. Meanwhile, in the working world, private firms are complaining about a shortage of skilled labor. End Summary.

Private Economists Forecast a Slower 2006

¶2. (U) The Malaysian Institute of Economic Research (MIER) has revised downwards its growth forecast for 2006 from 5.5% to 5.2%. Most private forecasts are now in the 5.0%-5.5% range. MIER expects growth to slow even further in 2007 to 4.8%. Speaking at a July 24 economic briefing, MIER Executive Director Dr. Mohamed Ariff said he expects domestic demand to decrease due to higher oil prices and interest rates. He also expects the world economy to decelerate in 2007, leading to lower demand for Malaysia's exports. While domestic investment will increase with the implementation of the Ninth Malaysian Plan (9MP; the government's five-year development plan), Dr. Ariff anticipated a lag before 9MP projects could be translated into growth boosting activities.

Government Officials Remain Optimistic

¶3. (U) At the same July 24 seminar, Deputy Finance Minister Ng Yen Yen told reporters the government is confident of 6.0% percent growth in 2006. "The government has "put in place initiatives to unleash the power of the private sector," she asserted. Separately, Finance Minister II Nor Mohamed Yakcop also upheld the 6.0% growth target this year. However, he covered himself by saying if there were to be any revision of the target rate, Prime Minister Abdullah would announce it when he tables the 2007 Malaysian

Budget on September 1. (Comment: The difference between 6.0% and 5.0% is politically significant. The Ninth Malaysia Plan projects an average growth rate of 6.0% for 2006-2010 (see reftel). It will be very hard to achieve this average if economic growth falls short in the initial years.)

Inflation Lingers

¶4. (U) Malaysia's consumer price index (CPI) rose a lower than expected 3.9% year-on-year in June, after recording a similar increase in May. Analysts expected higher inflation following the government's June 1 approval of a 12% increase in electricity rates. The CPI also increased 3.9% year-on-year for January through June in 2006. MIER's Dr. Ariff said inflation is a major concern, especially the secondary effects on prices of goods following increases in transportation and energy costs. Ariff noted, however, that Malaysia's inflation is cost-pushed, which tends to produce a one-off surge in prices. He did not expect a further boost unless oil prices escalate to a much higher level. MIER projects 4.0% inflation in 2006 and 3.3% in 2007.

Interest Rate Expectations

¶5. (U) Mirroring Dr. Ariff, Bank Negara Governor Zeti Akhtar Aziz told reporters in Jakarta July 25 that the inflation rate might average 3.5% to 4.0% this year as there had been no "second-round" effects from higher fuel and electricity prices. Zeti observed that if

inflation is cost-pushed, then there needed to be adjustments in the real economy and a prompt monetary response might not be warranted. Her remarks split analysts' views as to whether the Central Bank will raise the overnight policy rate (OPR) by another 25 basis points at the next monetary policy meeting July
¶28. The OPR currently is 3.5%. Interest rate differentials between the Malaysian and U.S. rates remain wide at 175 basis points. Lee Heng Guie, chief economist at CIMB bank, who had previously predicted another rate hike, is not so sure now. He nevertheless believes Bank Negara will need to increase the rate by another 25 basis points before the end of the year. (Comment: Even with a 25 point increase, the OPR would still be negative in real terms at current rates of inflation.)

¶6. (U) Commenting on interest rates, Dr. Ariff urged Bank Negara not to rush into raising rates as it could hurt the economy if external demand slackens in the fourth quarter. He argued for keeping lending rates unchanged, but forcing deposit rates up, as he believes the profit margin of banks remains wide. (Comment: Local bankers would not agree.) However, Ariff admitted that there is space for upward adjustment in both lending and deposit rates.

The Depegged Ringgit - One Year Old

¶7. (U) On July 21, the ringgit celebrated the first anniversary of the removal of its RM 3.8 to $1.00 peg. After one year the ringgit has appreciated just 2.8% against the dollar, and currently states at RM 3.693 to the dollar. On May 10, the ringgit hit an 8-year high to reach 3.57 against the dollar, but it since has weakened along with other regional currencies. Rebutting an earlier press report that he was not pleased with the ringgit performance, Finance Minister II Nor Mohamed Yakcop said the government was not

concerned as international market forces determine the currency's floating rate. Most private economists continue to believe the ringgit is undervalued. MIER's Dr. Ariff expects the currency to appreciate to RM 3.5 to $1.00 by the end of the year.

Help Wanted

¶8. (U) Despite widespread stories in the press alleging that there are thousands of unemployed Malaysian college graduates, many firms maintain that there is a significant shortage of qualified workers in the labor market. New evidence for this comes from a survey of small and medium sized enterprises (SME's) conducted by the Socioeconomic and Environmental Research Institute (SERI) of Penang. Penang is arguably Malaysia's most developed state, but 100% of the responding firms cited a shortage of skilled workers as a matter of concern. 58% complained about low worker productivity, while 38% expressed dissatisfaction with Malaysian labor laws that make it difficult to fire unproductive or troublesome workers.

¶9. (U) SERI's research suggests that Penang (and probably other Malaysian) SME's face a significant disadvantage in the competition for highly qualified workers as they cannot compete with the pay levels offered by multinational corporations (MNC's). The idea of using stock and profit sharing mechanisms as an incentive to attract workers to start up ventures has yet to take hold in Malaysia. The survey found that the average salary for a newly-hired engineer with a master's degree was RM 2,500-RM 3,000 per month (about $675-$810). Average earnings for a skilled production worker were RM 30 or more per day (about $8.10).

¶10. (U) Comment: The SERI survey results suggest two conclusions. First, the shortage of qualified workers in Malaysia is real and if not addressed could become a drag on the economy. Second, the extra challenges facing SME's may limit the expansion of locally-grown

enterprises, leaving Malaysia more dependent on investment by MNC's for its future growth and development. A third thought is that the Malaysian government may need to consider ways to steer college students towards academic programs that would make them more employable.

LAFLEUR